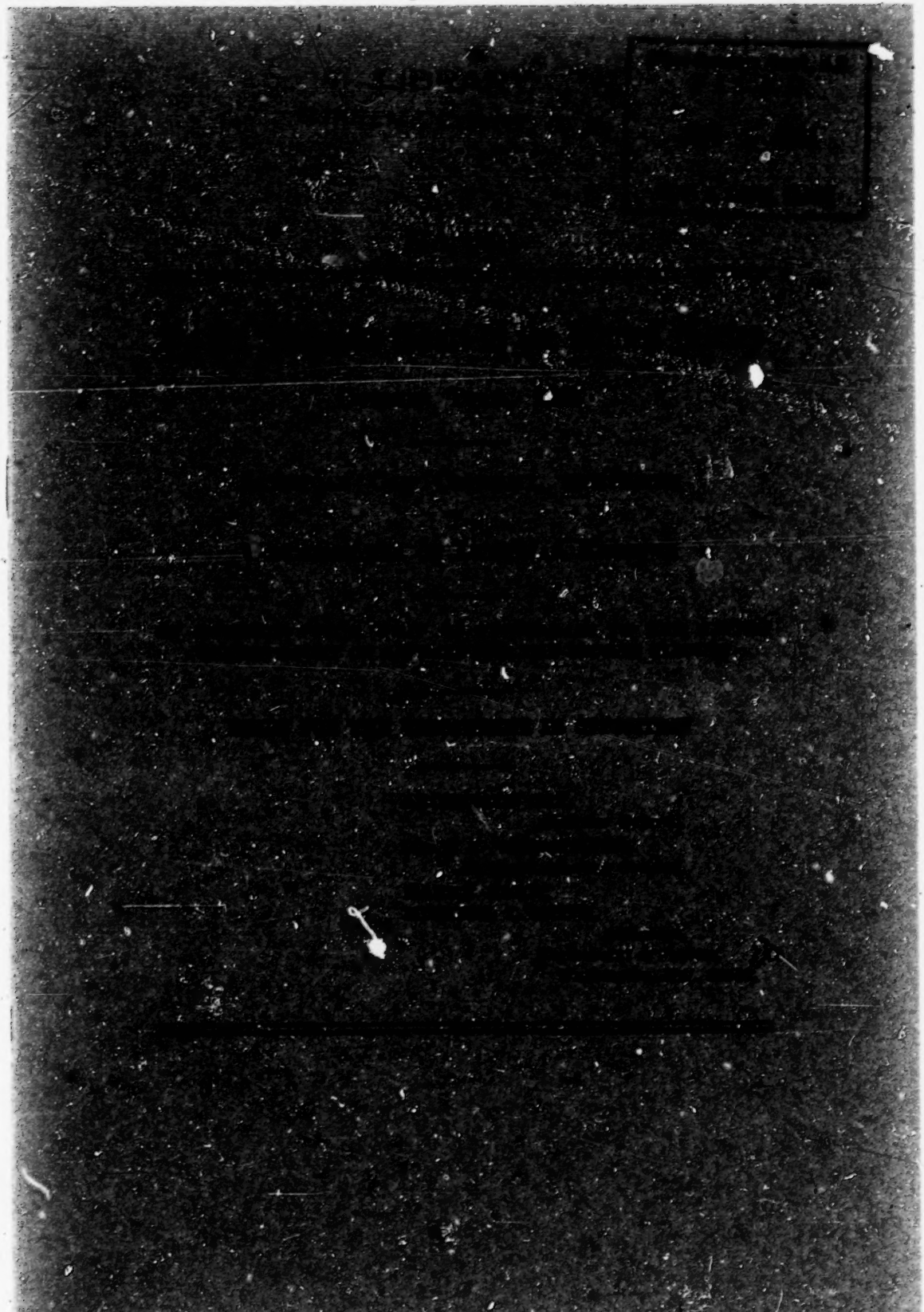

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In the Supreme Court of the United States

OCTOBER TERM, 1963

No. 656

AMERICAN CAN COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (R. 15–52) is reported at 37 T.C. 198. The opinion of the court of appeals (R. 165–170) is reported at 317 F. 2d 604.

JURISDICTION

The judgment of the court of appeals was entered on May 29, 1963. (R. 171–172.) The taxpayer's petition for rehearing (R. 173–190) was denied on July 8, 1963. (R. 191–198.) On October 1, 1963, the taxpayer's time for filing a petition for a writ of certiorari was extended by order of MR. JUSTICE HARLAN

to and including December 5, 1963. The petition for certiorari was filed on December 4, 1963. The jurisdiction of this Court is invoked under 28 U.S.C. 1254.

QUESTIONS PRESENTED

1. Whether the courts below erred in holding that the can-closing machines sold by the taxpayer during the taxable year in issue constituted property held primarily for sale to customers in the ordinary course of business within the meaning of Section 117 (a) and (j) of the Internal Revenue Code of 1939, and that the taxpayer's sales profits, therefore, were taxable as ordinary income and was not as capital gains.

2. Whether the taxpayer is entitled to change its method of accounting for vacation pay and state property tax expenses without first obtaining the Commissioner's agreement to such a change.

STATUTE AND REGULATIONS INVOLVED

Sections 41, 43, and 117(j) of the Internal Revenue Code of 1939 (26 U.S.C., 1952 ed.) are set forth at pages A1–A4 of the petition. Sections 39.41-2 and 39.43-2 of Treasury Regulations 118 (1939 Code) are set forth in relevant part in the Appendix to this brief, *infra*, pp. 13–15.

STATEMENT

Closing Machine Sales.—The taxpayer has been the nation's leading manufacturer of sanitary food and beverage containers ever since the early 1900's. It also manufactures can-closing machinery, and for many years it followed a policy of only leasing this equipment at a nominal rental so as to promote sales

of its containers. (R. 16–17, 166–167.) In 1949 this policy was judicially determined to be in violation of antitrust laws and subsequent proceedings were held to determine the appropriate remedy. The Government urged that a decree be entered ordering the complete divesture of the taxpayer's closing equipment operations. The taxpayer, however, sought a less drastic decree and offered to undertake a closing equipment sales program as part of its regular business operations. (R. 17–18, 167.) The taxpayer was successful in winning court approval of the alternative proposal, and in 1950 a decree was entered providing for a sales program under the supervision of a special master and the Department of Justice. (R. 18–22, 167.)

Following the entry of the antitrust decree, the availability of the taxpayer's machinery for purchase as well as lease was made known to the trade through notices to lessees and by advertisements. (R. 22, 27–28.) The taxpayer also continued to manufacture closing equipment and in the fall of 1950 it established a closing machine department, with three geographical divisions, which was responsible for the manufacture, design, leasing, sales and servicing of the equipment. (R. 24, 27.) In 1953, the taxable year in question, the taxpayer sold a total of 3,830 machines for a total recognized gain of $5,857,249.38. (R. 26.) Most of these machines were manufactured before the antitrust decree, but some were produced afterward. (R. 167.)

The taxpayer reported its total recognized gain from machinery sales in 1953 as long-term capital

gain. The Commissioner, however, determined that these profits were taxable as ordinary income, and the full Tax Court, one judge dissenting, sustained this determination. (R. 32–36, 46.) The court below affirmed this part of the Tax Court's decision. (R. 167–168.)

Accounting for Vacation Pay and Property Tax Expenses.—For all of its taxable years, up to and including 1953, the taxpayer accounted for and deducted employees' vacation pay and state property taxes in the taxable year in which such expenses were actually paid rather than in the year in which liabilities therefor accrued. Thus, on its 1953 return the taxpayer deducted the amounts of $5,853,970.70 and $1,596,751.42, which sums represented vacation pay and state tax expenses, respectively, the liabilities for which accrued in 1952 but which were paid by the taxpayer in 1953. (R. 29–31, 169.)

The taxpayer's liability for vacation payments made in 1954, in the amount of $6,889,165.34, and for 1954 state property taxes, in the amount of $1,659,773.59, accrued in 1953, but the taxpayer[1] claimed no deduction therefor in its 1953 income tax return. A claim for a deduction on account of these expenses, and of a resulting overpayment of income and excess profits taxes reported for 1953, was made by the taxpayer in its Tax Court petition for a re-

[1] In accordance with its prior method of accounting the taxpayer deducted these amounts on its 1954 return. (R. 29–31, 104–105.)

determination. (R. 30, 31.)[2] The taxpayer has never sought the Commissioner's consent to this change in its method of accounting for vacation pay and state tax expenses. (R. 29, 169.)

The Tax Court (R. 36–46), with four judges dissenting (R. 46–52), allowed the accounting change sought by the taxpayer, but the court below reversed (R. 169–170.)

ARGUMENT

The Court of Appeals correctly applied the law to the particular facts of this case. There is no conflict of decisions and no other cause for review.

1. Under the Internal Revenue Code gains from the sale or exchange of capital assets are taxed at preferential tax rates. Sections 117 (a) and (j) of the Internal Revenue Code of 1939 expressly exclude from the category of capital assets "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" (Pet. A2), and thus gains from such property are taxed at ordinary income rates. As the two courts below determined, this case falls squarely within the exclusion from the statutory definition of capital assets.

There is no doubt that prior to the antitrust proceeding the taxpayer's business policy was to lease its can-closing equipment as an inducement to customers to purchase its line of food and beverage containers.

[2] The parties have stipulated that if the taxpayer is allowed the claimed deductions, the sums actually deducted by the taxpayer on its 1953 return shall be disallowed. (R. 30–31.)

(R. 17, 167.) And, as the courts below recognized (R. 35, 168), there is also no doubt that had the taxpayer been willing to divest itself of the closing equipment branch of its business—as the Government had urged as a proper remedy for the taxpayer's violation of the antitrust laws (R. 17–18, 167)—it would have been entitled to report its net liquidation proceeds as capital gains. See *Smith* v. *Commissioner*, 232 F. 2d 142 (C.A. 5th). But the taxpayer would not agree to a divesture order and, instead, it sought and obtained permission to undertake a sales program relating to its can-closing machinery. To this end, the taxpayer set up a sales department, advertised the availability of its machines for sale, and continued to manufacture can-closing equipment. (R. 24, 27, 28, 167.) Thereafter, as the courts below held, the taxpayer held the closing equipment for sale as part of its regular and ordinary business.

Nor is the reason why the taxpayer adopted its new method of doing business important. *Ehrman* v. *Commissioner*, 120 F. 2d 607, 610 (C.A. 9th), certiorari denied, 314 U.S. 668. What matters is that by choosing not to accept the divesture order and by deciding to continue in the closing-equipment business knowing that the machinery would have to be offered for sale, the taxpayer put itself in the dual business of selling as well as renting closing equipment. *S. E. C. Corp.* v. *United States*, 241 F. 2d 416 (C.A. 2d), affirming *per curiam*, 140 F. Supp. 717 (S.D.N.Y.), certiorari denied, 354 U.S. 909; *Rollingwood Corp.* v. *Commis-*

sioner, 190 F. 2d 263, 266 (C.A. 9th); *Recordak Corp. v. United States* (Ct. Cl. No. 455–59), decided December 13, 1963. The closing equipment sold in 1953 was held with the substantial purpose of sale to customers in the ordinary course of the taxpayer's business, and the courts below did not err in so holding.

2. Section 41 of the Internal Revenue Code of 1939 (Pet. A1) provides that the net income of a taxpayer shall be computed upon the basis of the taxpayer's annual accounting period in accordance with the method of accounting regularly employed by such taxpayer in keeping his books, unless the Commissioner determines that the method the taxpayer employs does not clearly reflect income. The present taxpayer employed the accrual method of accounting (R. 29) except that each year it consistently deducted employees' vacation pay and certain state property taxes when these expenses were actually paid and not in the preceding year when the liabilities therefor accrued (R. 29, 30–31). This method of deducting such expenses was not in accord with a true accrual system of accounting (R. 169), but it had never been questioned by the Commissioner, who had accepted the taxpayer's tax returns filed on that basis.

Changes in the method of accounting employed by a taxpayer are governed by the regulations. Section 39.41–2(*c*) of the regulations (Regs. 118 (1939 Code), Appendix, *infra*, pp. 13–14), provides that a taxpayer

who changes "the method of accounting employed in keeping his books" must secure the prior consent of the Commissioner, that a change in the method of accounting includes "any change in the accounting treatment of items of income or deductions," that application must be made to the Commissioner for permission to make the change, and that such permission "will not be granted unless the taxpayer and the Commissioner agree to the terms and conditions under which the change will be affected." An interpretive Revenue Ruling provides that the requirement that the Commissioner's consent be obtained applies to a change in treatment of any "material item", and "whether or not the taxpayer regards the method from which he desires to change to be proper." (Rev. Rul. 59-285, 1959-2 Cum. Bull. 458, 459-460).[1] The taxpayer here has attempted to change its consistent treatment of two significant and material items. Its action in this respect is a change in its method of accounting within the meaning of the applicable Treasury Regulations and Revenue Ruling, and that is true even if its former consistent method of deducting the expenses in question was not correct under the accrual accounting system. *Wright Contracting Co. v. Commissioner*, 316 F. 2d 249, 254 (C.A. 5th).

[1] In the 1954 Code, the requirement of consent to any change of accounting methods, formerly found only in the regulations, was written into the statute (§ 446(e)). The regulations, in turn, now expressly provide that any change "in the treatment of a material item" is a change of method and that consent must be obtained regardless of the propriety of the prior method (Regs. (1954 Code), § 1.446-1(e)(2)(ii)).

certiorari denied, 375 U.S. 879; *Commissioner* v. *O. Liquidating Corp.*, 292 F. 2d 225, 230–231 (C.A. 3d), certiorari denied, 368 U.S. 898; *Advertisers Exchange, Inc.* v. *Commissioner*, 25 T.C. 1086, affirmed *per curiam*, 240 F. 2d 958 (C.A. 2d).

The court of appeals did not hold that the taxpayer will never be able to conform its system of accounting for the material items in question to a strict accrual method. In accordance with the Commissioner's position before that court and before the Tax Court, the appellate court has merely held that the matter must first be taken up with the Commissioner, who will then be in a position to protect the government's interests. (R. 169–170.) The propriety of this determination is apparent in view of the purpose of the regulation requiring not only the consent of the Commissioner to a change in accounting method, but also an accompanying agreement as to the terms and conditions under which the change will be effected. The regulation seeks to remedy the distortion of income (to the detriment of the government) which results from "virtually any material change in the method of reporting income or deduction items". *Commissioner* v. *O. Liquidating Corp.*, *supra*, p. 230; see also *Kahaku Plantation Co.* v. *Commissioner*, 132 F. 2d 671 (C.A. 9th). When consulted in the first instance, the Commissioner may remedy the distortion brought about by the proposed change by withholding his consent until the taxpayer agrees to adjustments designed to prevent omission of income items or a duplication or bunching of

deduction items as a result of the change.' See *Brookshire* v. *Comissioner*, 273 F. 2d 638 (C.A. 4th), certiorari denied, 363 U.S. 827.

The taxpayer alleges conflict with (Pet. 21) a "long line of Supreme Court cases", especially *United States* v. *Consolidated Edison Co.*, 366 U.S. 380, and *United States* v. *Anderson*, 269 U.S. 422. None of the cases cited by the taxpayer or by the Tax Court majority, however, involved the question of a taxpayer's right to change a consistent method of accounting without the Commissioner's consent. As the court below pointed out (R. 169), in the *Consolidated Edison Co.* case the Commissioner raised only the question of the proper year of accrual of the item under general accrual principles and did not oppose the taxpayer's change of treatment—which caused no bunching—should the taxpayer be correct as to the time of accrual.[4] And the *Anderson* case did not

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[3] In this case the accounting change proposed by the taxpayer would result in a distortion caused by the bunching of expenses for the taxable year 1952. According to the stipulation of the parties (R. 104, 105), the 1953 expenses disallowed by the Tax Court would be allowed for 1952, that being the year in which those expenses actually accrued. That procedure would bunch two years' expenses in 1952—both the deduction actually taken on the cash basis and the one that accrued in 1952 but which was taken in 1953. The taxpayer has not agreed to terms and conditions which would alleviate this distortion, a distortion that is particularly significant because 1952 was an excess-profits-tax year.

[4] *Consolidated Edison* presented only "the very narrow issue" (366 U.S. at p. 387) whether the remittance by an accrual basis taxpayer of a contested state tax assessment constituted "payment" of the contested part of the assessment, so as to render it accruable in the year of remittance, or whether liability for the tax accrued in the later year when the con-

involve a change from a consistent method of accounting even on its facts. The sole question there was the proper year of accrual (1916 or 1917) of an expense item under the Revenue Act of 1916, 39 Stat. 756, Section 13(d), which for the first time authorized use of the accrual system.[8]

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test was terminated. The Court's opinion is to be searched in vain for any discussion, much less a holding, regarding a taxpayer's right unilaterally to change his method of accounting.

[8] Although it is apparently not relied upon by the taxpayer as a basis for certiorari (see Pet. 19), *Beacon Publishing Co.* v. *Commissioner*, 218 F. 2d 697 (C.A. 10), is arguably in conflict with the decision below. That case may be distinguished, however, on the ground that the change involved there did not result in a bunching of deductions nor any overall avoidance of taxes, while the change sought here would result in the bunching of two years' deductions in an excess-profits-tax year (1952). See 218 F. 2d at 702. The *Beacon Publishing* case, moreover, was the first case to consider the issue; the opinion discussed the question only briefly; and all of the later cases have rejected its holding. *Advertisers Exchange, Inc.* v. *Commissioner*, 240 F. 2d 958 (C.A. 2), affirming 25 T.C. 1086; *Commissioner* v. *O. Liquidating Corp.*, 292 F. 2d 225, 230–231 (C.A. 3), certiorari denied, 368 U.S. 898; *Wright Contracting Co.* v. *Commissioner*, 316 F. 2d 249, 254 (C.A. 3), certiorari denied, 375 U.S. 879. Additionally, the legal context of the question has been significantly changed under the 1954 Code, since the requirement of consent has now been written into the statute, and the regulations now expressly require that consent be obtained regardless of the propriety of the treatment sought to be changed (see note 3, *supra*). In view of the weight of the opposing authority and the incorporation of the rules into the statute and regulations, there is a substantial likelihood that the Tenth Circuit, if faced with the question again, would now acquiesce in the majority view, thereby eliminating whatever conflict may be said to exist. This Court denied certiorari in the *O. Liquidating Corp.* case despite an asserted conflict with *Beacon Publishing*, and there is even less reason now to review the question.

CONCLUSION

The decision below is correct, and, for the reasons stated, the petition for certiorari should be denied.

Respectfully submitted.

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JANUARY 1964.

APPENDIX

Treasury Regulations 118 (1939 Code):

SEC. 39.41-2 *Bases of computation and changes in accounting methods.*—(a) Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. * * *.

(b) The true income, computed under the Internal Revenue Code and, if the taxpayer keeps books of account, in accordance with the method of accounting regularly employed in keeping such books (provided the method so used is properly applicable in determining the net income of the taxpayer for purposes of taxation), shall in all cases be entered in the return. If for any reason the basis of reporting income subject to tax is changed, the taxpayer shall attach to his return a separate statement setting forth for the taxable year and for the preceding year the classes of items differently treated under the two systems, specifying in particular all amounts duplicated or entirely omitted as the result of such change.

(c) A taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. For the purposes of this section, a change in the method of accounting employed in keeping books means any change in the accounting treatment of items of income or deductions, such as a change from

cash receipts and disbursements method to the accrual method, or vice versa; a change involving the basis of valuation employed in the computation of inventories (see §§ 39.22(c)-1 to 39.22(c)-8, inclusive); a change from the cash or accrual method to the long-term contract method, or vice versa; a change in the long-term contract method from the percentage of completion basis to the completed contract basis, or vice versa (see § 39.42-4); or a change involving the adoption of, or a change in the use of, any other specialized basis of computing net income such as the crop basis (see §§ 39.22(a)-7 and 39.23(a)-11. Application for permission to change the method of accounting employed and the basis upon which the return is made shall be filed within 90 days after the beginning of the taxable year to be covered by the return. The application shall be accompanied by a statement specifying the classes of items differently treated under the two methods and specifying all amounts which would be duplicated or entirely omitted as a result of the proposed change. Permission to change the method of accounting will not be granted unless the taxpayer and Commissioner agree to the terms and conditions under which the change will be effected. See section 22(d) and §§ 39.22(d)-1 to 39.22(d)-7, inclusive, with respect to changing to the last-in first-out method of inventorying goods.

* * * * * * *

SEC. 39.43-2 *When charges deductible.*— * * *. A taxpayer has the right to deduct all authorized allowances and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he cannot deduct them from the income of the next or any succeeding year. It is recognized, however, that particularly in a going business of any magnitude there are cer-

tain overlapping items both of income and deduction, and so long as these overlapping items do not materially distort the income they may be included in the year in which the taxpayer, pursuant to a consistent policy, takes them into his accounts. * * *.

U. S. GOVERNMENT PRINTING OFFICE : 1954